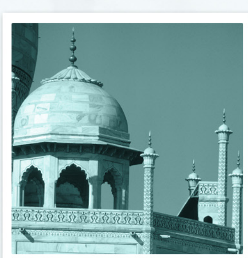
OVERVIEW OF ISLAMIC FINANCE

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BY MAHMOUD AMIN EL-GAMAL

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Overview Of Islamic Finance

By Mahmoud Amin El-Gamal[2]

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WHAT IS ISLAMIC FINANCE?

Islamic finance started as a small cottage industry in some Arab countries in the late 1970s. It distinguishes itself from conventional finance in its ostensible compliance with principles of Islamic law, or Shari'a.[3] Its growth has been accelerating ever since, in terms of the number of countries in which it operates, as well as the areas of finance in which it has ventured. However, reliable data are not available on Islamic finance at the country, regional or global levels.[4] In recent years, the industry has attracted a number of western multinational financial institutions, such as Citigroup and HSBC, which started offering Islamic financial products in some Arab countries (notably Bahrain and the United Arab Emirates), and to a lesser extent in the western world (including the U.S., where HSBC offers various Islamic financial products in New York, including home financing, checking accounts, etc.). A number of Islamic financial products also involve the acquisition of assets (e.g., real estate, small corporations, etc.) in the west (including the U.S.) in "Islamically structured" financing deals.

Islamic finance relies crucially on three sets of individuals with complimentary skills: (i) Financial professionals who are familiar with conventional financial products, as well as the demand for "Islamic" analogues of those products within various Muslim communities around the world, (ii) Islamic jurists (*fuqha* or experts on classical jurisprudence developed mainly between the 8th and 14th Centuries), who help Islamic financial providers to find precedent financial procedures in classical writings, upon which contemporary analogues of conventional financial products can be built, and (iii) lawyers who assist both groups in structuring Islamic analogue financial products,

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[2] Mahmoud Amin El-Gamal is Professor of Economics and Statistics at Rice University. He is Chair of Islamic Economics, Finance and Management in the Department of Economics. From May 2004 until December 2004 he was Islamic Finance Scholar-in-Residence at the U.S. Treasury Department.

[3] Shari`a literally means "the way" and is the Arabic term for Islamic Law as a way of life, comparable to the Hebrew *Halachah*). *Fiqh*, commonly translated as jurisprudence, is the interpretation of Shari`a for specific circumstances by specialized *fuqha*, or jurists.

[4] One can find several quoted figures, used primarily for informational purposes. However, there appears to be no reliable statistical basis for those numbers, so we have to settle for qualitative growth description.

while ensuring their compliance with all applicable and relevant legal and regulatory constraints.[5] Due to the industry's small size, a limited number of key players in each of those three categories have emerged as clear leaders.

HISTORICAL ROOTS OF ISLAMIC FINANCE

In the late 19th Century, the Ottomans introduced western-style banking to the Islamic world to finance their expenditures. While some Islamic jurists approved of modern banking practices, the majority found those practices to be violations of Islamic prohibitions against usury (Arabic term: *riba*, equivalent to the Hebrew *ribit*, and interpreted in its classical Biblical sense of any interest charge on loans, as opposed to the modern identification of usury with exorbitant interest). This resentment continued through the European colonial period, which lasted into the mid-20th Century. Islamic revival played a central role in the intellectual and social foundations of independence movements of the mid-20th Century. To many intellectual founders of the movement, political independence was to be supplemented with economic independence, through the definition of an Islamic economic system.

Early writings on what came to be known as "Islamic Economics" focused on macroeconomic developmental issues. By the 1970s, theoretical discussions of Islamic economics had given rise to practical discussions of Islamic finance, which turned juristic in nature: how can Muslims replace (conventional) financial practices (deemed to be usury/*riba*-based) with Islamic alternatives. Mid-Century literature suggested a profit-and-loss sharing silent partnership alternative to interest-based lending. The Arabic name of this contract is *mudaraba*, which is akin to the medieval European *Commenda* contract, and the Jewish *Heter Isqa*, designed similarly to avoid usurious lending in Jewish and early Catholic Law.[6]

This partnership-based focus survives in some Islamic financial practices (e.g., as a substitute for interest-bearing bank deposits). However, with the help of Islamic jurists and lawyers, as discussed in the introduction, Islamic financial practitioners were soon able to provide close analogues to almost all financial products, including various debt-instruments and fixed-income investment vehicles. We shall summarize some of the most widely used Islamic financial modes of operation in the following section.

MODES OF OPERATION IN ISLAMIC FINANCE

There are many contract and institutional forms used within the industry collectively known as Islamic finance. Specifics vary across countries and sectors. In this overview, we shall concentrate on some of the basic and central modes of financing that are most popular in Islamic finance today. When significant differences exist between implementations of a particular Islamic financial transaction in different regions or sectors, we note those differences briefly.

Consumer and Business Loan Alternatives

The juristic-based understanding of forbidden *riba*/usury suggested that Islamic finance has to be "asset-based", in the sense that one cannot collect or pay interest on rented money, as one does in conventional banking. Therefore, the easiest transactions to Islamize were secured lending operations, e.g., to finance the purchase of real estate, vehicles, business equipment, etc. Three main tools are utilized for this type of retail financing:

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[5] In this regard, Islamic finance has to adhere to multiple legal requirements; for clarity, this paper will refer to religious constraints as "juristic", and reserve the terms "legal" and "regulatory" for sovereign-imposed constraints.

[6] On *Mudaraba/Commenda*, see Udovitch, Abraham L. *Partnership and Profit in Medieval Islam*. Princeton, N.J: Princeton University Press, 1970. On the Isqa (alternatively spelled Iska) contract, see Stern, J. "Ribit: A Halachic Anthology", *Journal of Halacha and Contemporary Society,* 46, 1982. Sample Iska forms are available at: http://www.jlaw.com/Forms/iska_d.html.

a. **Buy-sell-back arrangements given the classical Arabic name: *murabaha*.** Under this transaction, the bank obtains a promise that its customer will purchase the property on credit at an agreed-upon mark-up (interest alternative), then proceeds to buy the property and subsequently sell it to the customer. These are analogous to the Federal Reserve's use of "matched-sale purchases." Depending on the jurisdiction and the object of financing, this may or may not impose additional sales taxes, license fees, etc. In the U.K., a recent regulatory ruling allowed Islamic financiers (HSBC) to practice double-sale financing without being subject to double-duty taxation. In 1999, at the request of United Bank of Kuwait (UBK), which at the time offered an Islamic home financing program in the U.S. (called Manzil USA, the program was terminated shortly thereafter), the Office of the Comptroller of the Currency issued an interpretive letter declaring *Murabaha* financing to be "functionally equivalent to or a natural outgrowth of secured real estate lending and inventory and equipment financing, activities that are part of the business of banking". [7]The markup in *Murabaha* financing is benchmarked (i.e., made to track) conventional interest rates.

b. **Lease-to-purchase or diminishing partnership arrangements under the Arabic names *Ijara* or *Musharaka Mutanaqisa*.** A typical structure requires the bank to create a special purpose vehicle (SPV) to purchase and hold title to the financed property. The SPV then leases the property to the customer, who makes monthly payments that are part-rent and part-principal. Rents are calculated based on market interest rates, allowing monthly payments to follow a conventional amortization table. The juristic justification of this practice is that principal parts of monthly payments increase the customer's ownership in the property, and allow him to pay less rent (on the part ostensibly owned by the bank through the SPV) over time, thus replicating a conventional amortization table. Again, at the request of UBK, the Office of the Comptroller of the Currency examined the typical structure of Islamic lease-to-own (*Ijara*) transactions, and reasoned as follows:[8]"Today, banks structure leases so that they are equivalent to lending secured by private property ... a lease that has the economic attributes of a loan is within the business of banking... Here it is clear that UBK's net lease is functionally equivalent to a financing transaction in which the Branch occupies the position of a secured lender...".

   An added advantage to lease financing is that Islamic jurists allow the SPV to issue certificates securitizing the lease (ostensibly, the certificates represent ownership of the underlying asset, and thus allow their holders to collect rent). In recent years, this has given rise to a booming securitization industry in Islamic Finance, as we shall discuss within the context of bond-alternatives. Here in the U.S., both Fannie Mae and Freddie Mac have purchased and guaranteed *Ijara*-based mortgages, subject to their note requirements (which required overcoming some legal and juristic hurdles). Those Islamic mortgage-backed securities are currently being marketed as fixed-income investment alternatives for Muslims.

c. **Recently, banks in Gulf Cooperation Council (GCC) countries have been offering consumer finance through a three-party contract known by the Arabic name *Tawarruq* (literally: monetization of some commodity).** This is a practice that Islamic banks have used with more sophisticated business clients for a number of years, but only recently introduced for consumer fi-

[7] Available on the OCC website at: http://www.occ.treas.gov/interp/nov99/int867.pdf.
[8] See http://www.occ.treas.gov/interp/dec97/int806.pdf.

nancing. For example, a customer wants to borrow $1000 using an Islamic Juristic-compliant mechanism. GCC Islamic jurists, relying on an opinion within the *Hanbali* school of jurisprudence, which is dominant in that region, allow the bank to buy $1,000-worth of commodities (e.g., wheat), and sell them to the customer on credit at a mark-up (equal to the interest rate they would have charged on a loan, perhaps plus compensation for the transaction costs associated with multiple sales). The customer may then turn around and sell the commodity to a third party (oftentimes the same party that sold it to the bank), collecting the desired cash immediately, with a deferred debt equal to principal plus interest. In 2004, at least one other bank in a GCC country announced a new *Tawarruq* facility. Since this type of financing can easily replace lending for any purpose (consumer loans, unsecured loans, etc.), it has allowed a number of conventional banks to announce that they will "Islamize" all of their operations. The most significant such announcement was that made by Saudi Arabia's National Commercial Bank, stating that it planned to Islamize all of its lending practices by 2005.

Corporate and Government Bond Alternatives

In its early stages of development in the 1980s and 90s, a number of bond alternatives were tried with very limited success. Some were based on profit and loss sharing (e.g., in Sudan and Pakistan), while others guaranteed the principal but did not guarantee a fixed rate of return (e.g., in Malaysia). Once the securitization of leases (discussed in the previous section) became fully understood, a significant number of corporate and government bonds were structured as lease-backed securities (under the Arabic name *Sukuk al-Ijara*).[9] In 2004, the largest issuance was by the Department of Civil Aviation of the United Arab Emirates for $750 million. The second largest was by the Bahrain Monetary Agency for $250 million. The latter was led by Citigroup, with heavy involvement of the Norton Rose law firm to structure the deal. A third interesting government issuance was by the German Federal State of Saxony-Anhalt for €100 million, which is heavily marketed in the Arab countries of the GCC as the first western-government issued Islamic bond. The two largest corporate Islamic bond issuances in the first half of 2004 were those of the National Central Cooling Company (of U.A.E.) for $100 million and Hanco Rent a Car in Saudi Arabia for $26.13 million.

Corporate bond issuances in the early part of 2006 totaled $10.2 billion, the most notable being the Dubai Ports issuance of the largest *sukuk* to date, a 2 year convertible $3.5 billion bond (profit and loss sharing).[10] In 2005, an estimated $11.4 billion in corporate *sukuks* were issued, up from $5.5 billion and $4.6 billion in 2004 and 2003 respectively. Sovereign issuances in 2006 total $2.7 billion thus far, up from $706 million in 2005, $1.5 million in 2004 and $1.2 million in 2003.[11] An additional $6.7 billion in sovereigns is slated to be issued for the remainder of 2006.[12]

A number of those issuances were made by SPVs, which buy some properties from the respective governments or corporations using bond-sale proceeds, and then lease the properties back, passing principal and interest back to bond-holders in the form of rent. A number of different U.S. and European investment banks are involved in the securitization process (e.g., Citigroup for the Bahraini and German state bonds, Credit Suisse First Boston for the UAE cooling company, and Barclays Bank with the Dubai Islamic Bank for the Dubai Ports Co.).

[9] *Sukuk* is the plural of *sakk*, an Arabic precursor of cheque, meaning certificate of debt or bond.
[10] Managed by Dubai Islamic Bank and Barclays Bank. Details about the *sukuk* structure, and thus about potential risk-structure differences from conventional bonds, are not available.
[11] Sovereigns include government-owned institutions, utilities,etc.
[12] Source: ISI Emerging Markets' Islamic Finance Information Service (IFIS). Data as of May 2006.

Lease-backed bonds are long-term securities, for which underlying physical assets allow secondary markets to exist. Shorter-term (Treasury bill-like) bonds are also issued on occasion by governments of countries with significant Islamic banking operations (e.g., Bahrain). Those are typically based on forward sales of some commodities, using the Arabic name *salam*, and adhering to the classical juristic

ruling that price must be paid in-full at the inception of a *salam*-sale. By utilizing what is called a "parallel *salam*", the bond-issuer can match a forward-purchase with a purchase-sale for the same commodities and the same delivery date, but initiated at different times. Thus, corn deliverable in six months can be sold forward today for $1 million, and then bought forward in three months (using a separate contract with a different counterparty) for $1.01 million. While residual credit, commodity and delivery risks may exist in this structure, issuers typically guarantee the contract so that the bond buyers would – in our example – be guaranteed 1% in 3 months. Since the underlying assets for this type of bond are debts, Islamic jurists ruled that they cannot be traded on secondary markets (except at face value, which defeats the purpose). Thus, they were originally envisioned as vehicles primarily for Islamic banks to hold to maturity. Recently, however, Bahrain has introduced some innovative repo (repurchase) facilities, to allow Islamic banks to use those bills more effectively for liquidity management.

Investment Vehicle Alternatives (e.g., Mutual Fund, Private Equity)

For investment in corporate equity, it was easy to see why Islamic investors should shy away from companies that produced products that are forbidden to Muslims (e.g., beer, pork products, etc.), as well as some others that Islamic jurists decided to forbid (e.g., weapons producers, cutting-edge genetic research, etc.). The issue of interest was much more difficult: Most companies either have excess liquidity – in which case they earn interest, or use leverage – in which case they pay interest. Islamic jurists decided to invoke the rule of necessity (the universe of equity securities to choose from would be too small if they exclude all companies that either pay or receive interest). They decided to impose three financial screens: (i) exclude companies for which accounts receivables constituted a major share of their assets; (ii) exclude companies that had too much debt; and (iii) exclude companies that received too much interest. After experimentation with different cutoff marks for financial ratios, the set of rules selected by the Dow Jones Islamic indices became globally accepted: (i) exclude companies whose receivables accounted for more than 45% of assets; and (ii) exclude companies whose debt to moving average of market capitalization exceed 33%. Many add a third rule related to the first: (iii) exclude companies whose interest income exceeds 5% (or, for some, 10%) of total income.

Dow Jones, and later Financial Times, launched their Islamic indices in the late 1990s, and continue to add various other Islamic indices paralleling their other conventional indices, with the smaller universe of equity securities. Mutual fund companies either mimic their screening rules, or obtain licenses from one of the indices, which they use as a benchmark. These types of mutual funds are usually dubbed "Islamic" or "Shari`a-compliant." While sales of mutual funds in general have done well in Saudi Arabia and GCC markets, Islamic mutual funds seem to have only a limited marketing advantage over conventional ones. In one study done by National Commercial Bank in Saudi Arabia, investors indicated that all other things equal, they would prefer an "Islamic" fund to a conventional one. However, if other things are not equal, they would prefer a conventional fund with better returns, or offered by a more reputable provider, to ones that are "Islamic" but inferior along those dimensions. Consequently, the total funds under management by Islamic mutual funds have – to date – fallen substantially short of initial expectations.

On the other hand, growing unanimity over the general screens used by Islamic mutual funds has enabled Islamic private equity and investment banking boutiques to thrive. Those institutions typically collect investor funds in GCC countries (investors from Saudi Arabia, Kuwait, and U.A.E.

being primary sources of funds). Through local subsidiaries or partners in the west (U.S.A. and U.K. being primary destinations for investment funds), collected funds are used to acquire real estate and small companies that pass the above mentioned screens, or whose debt can be restructured to pass them (oftentimes through lease-based leveraged buy-outs, a popular western mergers and acquisitions tool of the 1980s and 1990s). There are 134 registered equity funds, six hybrid funds, six sukuk funds, two Takaful funds (insurance), five leasing funds and eight real estate funds.[13]

Insurance Alternatives

The vast majority of Islamic jurists declared the use of, and investment in, insurance companies to be impermissible under Islamic jurisprudence. This prohibition is based on two considerations: the first consideration is that "safety" or "insurance" is not itself viewed as an object of sale in classical Islamic jurisprudence. Thus, Islamic jurists argued, the insured-insurer relationship is viewed to be one akin to gambling, wherein the insured as buyer pays periodic premia as price, but may or may not receive the object of sale (compensation in case of loss), depending on chance. The second consideration that prompted Islamic jurists to forbid insurance is the fact that insurance companies tend to concentrate their assets in interest-based instruments such as government bonds and mortgage-backed securities.

The alternative they proposed is marketed under the Arabic name *Takaful*, which has recently begun making inroads in Islamic countries, after years of slow growth. The main idea behind *Takaful* is similar to mutual insurance, wherein there is no commutative financial contract that allows one to interpret premium payments as prices and insurance claim fulfillment as an object of sale. Rather, policy holders are viewed as contributors to a pool of money, which they agree voluntarily to share in cases of loss to any of them. Early *Takaful* companies were in fact structured as stock insurance companies, but the language of "voluntary contribution" to insurance claimants was used to argue that the contract was not a commutative one. Inroads have recently been made by Bank Al-Jazira of Saudi Arabia by modifying its insurance to better approximate western-style mutual insurance, and the model appears to be boosting its underwriting success. Regardless of structure, both types of *Takaful* companies do not invest in conventional government bonds and fixed income securities. However, as seen elsewhere in this section, Islamized analogues of those securities have become increasingly available in recent years, further contributing to the industry's growth. Despite the industry's growth, it has not yet reached a critical size that would support the equivalent of re-insurance, or "re-*Takaful*", companies to emerge. Consequently, Islamic jurists have invoked the rule of necessity to allow *Takaful* companies to sell their risks to conventional re-insurance companies, with the provision that they should work to develop a re-*Takaful* company as soon as possible.

Bank Deposit and Fixed Income Security Alternatives

In the Islamic world, Islamic banks can only accept fiduciary deposits, for which they cannot pay interest, since interest would be considered usury/*riba* once the principal is guaranteed. On the other hand, they are allowed to accept "investment account" funds, which they may invest on behalf of the account holders, and share profits and losses thereof. This clearly gives rise to a moral hazard problem, and a regulatory issue regarding protection of investment account holders who are neither protected as creditors (first claimants), nor as stock-holders with representation on boards of directors. Attempts by significant juristic bodies to justify interest-bearing bank deposits have been strongly rejected by most Islamic jurists, especially the ones to whom

[13] As of February 2006. www.failaka.com.

[14] For a summary of this debate and its juristic grounds, see El-Gamal, Mahmoud "Interest and the Paradox of Contemporary Islamic Law and Finance", *Fordham International Law Review*, December 2003.

Islamic bank customers look for guidance.[14]

In the U.S., a number of attempts took place in the U.S. to license an Islamic bank, a number of conventional banks are offering Islamic financing products, and working towards offering FDIC-insured variable-interest (tied to rate of return on portfolio of Islamic mortgage, auto-financing, etc.) NOW, money market, and other types of bank accounts. Interpretation of such services as "deposits" is controversial, and their appeal to target clientele is uncertain. In particular, and in analogy to the limited appeal of Islamic mutual funds, it may be the case that potential Islamic bank customers who are sufficiently sophisticated to accept deposit insurance will also be sufficiently sophisticated to seek the best combinations of returns and offering institution-size. On the other hand, the novelty of "Islamic banking" availability, coupled with the possibility of obtaining FDIC insurance of the principal, may prove to be sufficiently attractive for a group of Muslims who have so-far shied away from depositing their funds in savings or money market accounts, as well as others who have such accounts but prefer to buy the "Islamic" brand-name.[15]

In the meantime, as we have shown, market-based fixed-income alternatives have been available for quite some time based on securitization. Thus, Islamic finance clients can buy Islamic mortgage-based securities, or invest directly in pools of securitized fixed-return Islamic financial products. In this regard, while securitized *Murabaha* (cost-plus credit sale receivable) portfolios are deemed non-tradable except on face value, Islamic jurists have allowed trading mixed portfolios of sale-based and lease-based receivables, provided that the latter constitute at least 51%. If the market for Islamic-finance assets continues to grow, the ability to offer all types of fixed-income instruments, including bank savings accounts, should become more common in the West. It may take time for Middle-Eastern and Asian clients to accept this notion, given the vigor with which they have constantly argued against interest-based transactions as the forbidden *Riba*.

GEOGRAPHIC DISTRIBUTION OF ISLAMIC FINANCE

Intensive efforts have been spent in recent years to harmonize Islamic financial practices, from creating accounting standards for Islamic financial products (through the Accounting and Auditing Organization for Islamic Financial Institutions, AAOIFI), to integration of those standards with global corporate and risk management standards (i.e., Basel Accords I and II) through the recently created Islamic Financial Services Board (IFSB). Those efforts are motivated by two objectives: (1) to create a worldwide network of financial markets, including the offshore markets in Labuan (off the Malaysian coast), Bahrain, and Dubai, thus enhancing depth and liquidity of markets for industry securities; and (2) to integrate the industry more effectively with the international financial system. However, country and region-specific features have not faded away. We list some of the defining features of Islamic finance in the various relevant sub-regions in this section.

Gulf Cooperation Council (GCC) Countries

Not surprisingly, the rise of Islamic finance in the late 1970s coincided with the two oil shocks of that decade, which created an immense amount of wealth. The earliest private Islamic banks of the modern era were Dubai Islamic Bank, Faisal Islamic Bank Egypt, and Faisal Islamic Bank Sudan, the latter two being sponsored by Prince Muhammad Al-Faisal, son of the late King Faisal of Saudi Arabia. Other early entrants in the industry were the various financial arms of Saudi Sheikh Saleh Kamel's Dallah Al-Baraka groups, and Kuwait Finance House, among others.

In its early stages, most governments in the GCC

[15] For instance, a small market exists for "*Halal* (permissible) meat", analogous to Kosher products, based on specific slaughter and processing procedures. Those products appeal to customers who otherwise would only consume vegetarian products, as well as others who would buy regular meat products but prefer to buy "*Halal*" meat.

region, and the Arab world more generally, were either hostile to, or at best ambivalent about, Islamic finance. Indeed, to most people's surprise, the latest country to allow Islamic banking in the region is Saudi Arabia, where the Saudi Arabian Monetary Authority has always been concerned about and averse to introducing non-standard banking practices.

However, demand for financial products allowed a number of local and western financial practitioners to create a small industry, using investment funds from the Gulf region, especially Saudi Arabia. Over the past decade, Bahrain has pursued Islamic finance as a significant niche that could allow it to build on its strong banking sector, perhaps to become a regional financial center. Local investment banking talent also emerged in Bahrain (e.g., First Islamic Investment Bank) and Kuwait (e.g., The International Investor) to capitalize on the growing industry, which had earlier centered in London and Geneva. Not to be outmaneuvered, a number of multinational financial institutions (e.g., Citigroup, HSBC, and UBS) set-up Islamic financial arms in the region (mainly in Bahrain and U.A.E.) to cater to commercial as well as investment banking needs within the Islamic finance niche.

Islamic finance arms of multinational banks, with their superior resources, later helped indigenous Islamic finance companies to establish the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), and most recently initiate the drive to get Central Banks, as well as the IMF and World Bank, to establish the Islamic Financial Services Board in Kuala Lumpur, Malaysia. We have already seen the primary role played by multinational investment banks in the most recent wave of Islamic bond issuances, both by sovereign states in the region (Bahrain and Qatar), as well as corporations.

Southeast, South and Central Asia

Malaysia developed one of the earliest mature Islamic finance markets in the mid-1980s. Initiatives to integrate ethnic Malays in the country's formal financial sector culminated in converting a pilgrimage savings plan into a full-fledged Islamic bank: Bank Islam Malaysia Berhad. Over the next two decades, conventional Malaysian banks were allowed to offer Islamic financial products through "Islamic windows". Malaysia's central bank, Bank Negara, began supervision of Islamic banking practices at its inception. Special bonds called Government Investment Certificates were issued to facilitate open market and inter-bank operations. Those bonds guaranteed the principal, but gave interest only as an unanticipated gift based on profitability of government investments. Malaysian Islamic money markets were successful early on, and attracted some investment capital from GCC investors eager to invest some of their capital in Islamic countries.

However, as advanced as the Malaysian Islamic financial sector was relative to its Arab counterparts, it suffered a fundamental drawback. Much of the development of that sector relied on a juristic opinion held by Malaysian Islamic jurists, who allowed trading debts and pure-debt instruments. That allowed Malaysia to evolve a highly efficient parallel Islamic financial system. However, Islamic jurists of other regions did not approve of this debt-trading practice. As the Arab market grew, and Malaysia feared that Bahrain would replace London as the sole center of global Islamic finance, Malaysians strove to harmonize their Islamic financial markets with Islamic financial practices elsewhere in the world. To emphasize its leading role in this industry, the Malaysian central bank led the creation of the Islamic Financial Services Board, which is now housed in Kuala Lumpur and relies on Malaysian contributions for running expenses. In the meantime, Malaysians continue to allow more innovation for their own domestic Islamic financial market, allowing conventional futures trading, debt trading, etc., and recently creating a deposit insurance mechanism for Islamic banking. Other countries in Southeast Asia, e.g., Indonesia, Singapore, etc. have relatively small Islamic financial sectors, which are likely to evolve as a hybrid between the Malaysian and the more conservative Arab and Pakistani models.

Pakistan is another interesting case to consider. General Zia-ul-Haqq, in his many efforts to use Islamic fervor for his regime's legitimacy, declared full-fledged Islamization of the financial sector in the 1980s. However, bankers merely continued their conventional banking practices, replacing the term "profit" with "interest". The Pakistani Shari`a Appellate Court repeatedly issued ultimatum orders to Islamize the system for real at various dates, but that proved impossible. A new Islamic banking initiative was started in 2004: there are four Islamic banks, two are in the pipeline and 15 conventional banks have Islamic branches. The State Bank of Pakistan (the Central Bank) appointed its own 5-member Shari'a board (Islamic juristic authority) composed of an Islamic jurist, accountant, lawyer, banker, and central bank representative and has posted a list of permissible Islamic banking contract forms on its website. This may be a prelude to more general imposition of Islamic banking practices in Pakistan.

Iran also declared the Islamization of its banking sector shortly after the Islamic revolution. However, since most banks were either national or nationalized, interest payments between those banks were seen to cancel out in the consolidated balance sheet, and were therefore permitted. For dealings with the public, some banks did not guarantee interest rates, but in practice paid rates equal to the interest rates determined elsewhere in the system. Hence, Iranian banking has not changed significantly before and after the revolution. Finally, a small number of boutique Islamic financial shops started in the various "stans" (especially Kazakhstan) in recent years, but there are no signs of an Islamic financial industry evolving in central Asia at this time.

Arab World excluding GCC

As previously noted, Faisal Islamic Banks in Egypt and Sudan were among the very first Islamic banks. Faisal Islamic Bank Egypt was established by special decree, and Islamic banking in Egypt remains extremely limited, although some state banks are allowed to offer Islamic transactions to fulfill the market demand. Official and public perceptions of Islamic banking in Egypt were severely damaged in the aftermath of massive failures of Islamist "fund mobilization companies" that apparently attracted remittances of many Egyptians working in GCC countries, ostensibly to invest in trading real assets, but in fact constituted pyramid schemes.

In contrast, Sudan Islamized its entire banking sector. A very conservative (and hence relatively inefficient) version of Islamic finance is followed in Sudan, for instance with government bonds based on profit-and-loss sharing partnerships. There are indications currently that banks in the Southern part of Sudan will be allowed to operate conventionally or Islamically as they please, while banks in the north will remain purely Islamic.

Elsewhere in the Arab and Islamic world, a number of GCC-based banks have had Islamic operations for a number of years. The general rise in Islamic sentiments in the region is accompanied with high levels of adherence to classical law in all matters ranging from dress-codes to finance. Consequently, countries that originally resisted Islamic banking are currently inviting it to satisfy their nascent demand. Recently, for instance, Lebanon increased substantially its Islamic banking profile with Saudi-based Al-Baraka, and Syria licensed its first Islamic bank, which is jointly Qatar-Syrian owned. One can expect private Islamic finance to continue to grow substantially all around the Arab and Islamic world. Depending on political environment, some governments may even opt for Islamization of some state-owned banks as a measure to limit capital flight and appease Islamist elements within their borders.

North America and Western Europe

Islamic finance has arisen in the West primarily as a result of the popularity of U.S., and to a lesser extent U.K. and German, financial assets among GCC investors, who are the primary financiers of Islamic finance. Whether we consider Islamic mutual funds that select among stocks on the NYSE and NASDAQ, commercial real estate investment, or acquisition target corporations, those

investors favor the legal transparency and lower risk associated with mature western markets. These investment preferences did not change after September 11, 2001. However, a combination of fear of asset-freezing dragnets and public image consciousness about being heavily invested in the West prompted indigenous and multinational Islamic finance providers to restructure transactions in a manner that gives those investors indirect investment access to those markets.

For the past three decades, Islamic finance practitioners have also attempted to tap the relatively educated and professional Muslim populations in the west (again, primarily the U.S. and U.K.). Arab banks have tried repeatedly, with mixed success, to engage in home and auto financing in the U.S. and U.K. (Al-Baraka was one of the earliest, United Bank of Kuwait coming later and utilizing some of its models). Most recently, Islamic Bank of Britain, Plc. (in part pioneered by Abu Dhabi Islamic Bank) was licensed in the U.K. in August, 2004. Western home-grown boutique financial institutions, structured as co-ops, savings and loans, and investment companies, also started in the late 1970s and 1980s, but remained very small in size. Recently, the securitization successes through participation of Fannie Mae and Freddie Mac have allowed the market for Islamic home financing to grow significantly in the U.S., with some providers seeking to sell hundreds of millions worth of GSE-guaranteed mortgage backed securities in GCC countries, as cheaper alternatives to investment banking and boutique private equity financial instruments. Participants in this industry, home-grown and foreign, have recently had a number of regulatory successes, including the above cited OCC letters, and potential FDIC approval of various depositary products in the U.S., as well as licensing of the first full-fledged Islamic bank and elimination of double-duty taxation for HSBC Islamic home financing in U.K. Islamic finance is likely to continue to grow in the U.S. and western Europe, but not to the extent expected by market participants who hope that a significant proportion of Muslims in those countries will participate in this industry. For instance, while Islamic mutual funds are widely accessible, they have only attracted a very small percentage of savings of Muslims in those countries. The market-size for Islamic mutual funds was over-estimated, and market-sizes for other Islamic financial products – estimates of which prompted many recent developments in legal and regulatory infrastructures – may very well be likewise over-estimated.

PROS, CONS, AND PRELIMINARY POLICY CONCLUSIONS

Islamic finance is an industry which in many ways tries to "reinvent the wheel," producing successive approximations of western financial practices. However, it is an industry that is likely to survive in the medium term, due to continued existence of customers who value Islamic jurist approval of its modes of operation. To the extent that Islamism in all its forms is on the rise, the industry is likely to continue to grow, but I believe its growth prospects are limited. However, its absolute size (though not known accurately) has already reached levels that require monitoring the sector, and ensuring the development of appropriate prudential regulations therein as well as harmonious development within the international financial system. We close with a list of the most important pros and cons of Islamic finance in the short to medium-term.

Islamic finance may have already succeeded in integrating some part of the global Muslim population (those who had decided not to deal with conventional finance) in the formal international financial system. In the process, Islamic jurists were forced to analyze classical Islamic jurisprudence in light of contemporary legal, regulatory, economic and financial systems. This gave rise to a continuing process of growth in Islamic jurisprudence, which ultimately may further produce an efficient integration of Muslims who had previously shunned the conventional financial sector. Moreover, recall that the primary market for Islamic finance is in developing countries – which may have formally borrowed modern legal, regulatory, and financial standards from advanced countries, but fall significantly short of

those standards in practice. In this regard, one may recall that provisions in laws of contracts under classical Islamic jurisprudence were, in essence, prudential regulations of that time. To the extent that those provisions are respected in Islamic financial practice (which is not necessarily the case), Islamic finance may in fact be a catalyst for improving financial practices in those countries. For instance, the focus on secured rather than unsecured lending (albeit being abandoned with the growth of *Tawarruq* financing), coupled with proper marking-to-market of asset values, can improve collateralization practices that have been non-existent or poorly implemented in some majority-Muslim countries, leading to catastrophic bad loan volumes that threaten their banking systems.

On the other hand, one cannot but conclude that the *modus operandi* of Islamic finance, including the evolving opinions of its professional Islamic jurists, is a prolonged reinvention of the financial wheel. One needs only to observe the evolution of standards from original practices of *Murabaha*, to more advanced *Murabaha* with agency provisions, and finally *Tawarruq* practices, to notice how competition and better understanding of banking practices brings Islamic financial practice closer to its conventional counterpart. However, the industry's survival to-date has relied on its captive market of pious Muslims, who may abandon it if full convergence is obtained. Moreover, just as some manufacturers may delay the introduction of their latest products to smooth demand over time, Islamic financial providers prefer to introduce "innovations" (better approximations of conventional financial practice) gradually, to extract the most rents, and gently prepare their clientele. This implies that some level of inefficiency is intrinsic to this industry, taking the forms of transactions costs, additional legal costs, and fees for Islamic jurists. Moreover, the industry by its very nature has a longer lag in "chasing past returns."[16] However, due to catering to a captive clientele, the industry has been able to survive and continue its growth despite this continued inefficiency.

With time, competition is likely to reduce inefficiency in the industry (though it cannot be eliminated if the industry were to maintain its Islamic character). To attain higher levels of efficiency, Islamic jurists will have to continue their process of understanding modern financial practices, and developing an Islamic jurisprudence that is appropriate for today's legal, regulatory, and financial realities. In this regard, while some developments facilitate Islamic finance (e.g., the English elimination of double duty taxation on HSBC Islamic financial structures involving double-sale for financing purposes), one should not encourage regulatory adjustments to accommodate Islamic financial practices. Islamic finance has shown its ability to adapt to existing regulatory frameworks (e.g., recent attempts to develop FDIC-insured Islamic money market accounts, CDs, and NOWs in the U.S.).[17] I have also argued that this adaptation eventually changes the very Islamic jurisprudence upon which the industry is built. Toward that end, regulators' primary concern should continue to be protection of consumers of financial services, as well as safety, stability, and fairness of the overall financial system. To the extent that current Islamic jurisprudence has not yet reached a level of maturity that allows it to coexist harmoniously within the best legal and regulatory stan-

[16] For instance, Islamic REITs are currently very popular (June 2004), when REITs were in fact a very good investment in 2001-2. Similarly, a number of new "Islamic Hedge Funds" are beginning to reach the market now, again years after the optimal performance of conventional hedge funds. This chasing of past returns has proved taxing in the past. For instance, the Dow Jones Islamic Index (DJII) debt ratio screen was originally set for debt to assets. In the middle of the tech bubble in the late 1990s, jurists changed the 33% cutoff for debts to assets into one for debts to market capitalization (just as market capitalization was soaring). That allowed DJII-licensed mutual funds to make spectacular returns for a very short period of time, by being NASDAQ heavy. Once technology sector stocks crashed, many of the stocks had to be excluded from the DJII universe because their market capitalizations had fallen too low (i.e., they bought high and sold low), disallowing investors to benefit from the partial recovery that ensued.

[17] NOWs are negotiable order of withdrawal accounts

dards, it would be unwise to push market participants toward standardizing their financial and religious-legal standards at this time. Premature standardization of the current inefficient practices may become tantamount to irreversible codification of what can be considered an anachronistic financial model.